



Vision Paper 2: Bridging the Inclusive Finance Gap

Enabling financial parties to fund viable agribusinesses
in developing countries

SNV



TheRockGroup



Introduction

Based on experience from the Partnering for Value project, this paper analyses the finance gap for agricultural SMEs¹ and possible solutions to close it. We aim to provide both private investors and international donors with recommendations towards their strategy regarding agricultural finance.

International donors can play a vital role in bridging the gap between financing demand from and supply for agricultural SMEs, creating access to finance for 'the missing middle'. Bridging this gap will also benefit smallholders who are linked to these SMEs. SMEs are often looking for capital to invest in upgrading their supply chain and securing their sourcing relationship with farmers. Using investments, smallholders can deliver higher quality products, get a better price and thus better margins. This way, funding agricultural SMEs might be seen as an indirect investment in (groups of) smallholder farmers.

This paper is part of a set of three Vision Papers developed by SNV in cooperation with TheRockGroup, based on learnings from the Partnering for Value Project. This project (2015-2018) aims to develop best-practices on brokering successful Public-Private-Producer Partnerships (4Ps) within the context of IFAD funded rural development projects.

During our work in the project countries, we made interesting observations on this matter. In countries where matching grants or funds were available (i.e. El Salvador, Mozambique and Vietnam) the development of the 4P business cases turned out very different from the countries where those funds were lacking (i.e. Uganda and Senegal). The matching funds clearly provided a kick-start to the development of the partnership, even though bureaucratic processes around approval and expenditure also raised concerns over the implementation speed. As matching funds are not available everywhere, it makes sense to zoom in on current bottlenecks for the financial sector to invest in 4P business cases and how these can be addressed.

Experience from the Partnering for Value project has given us insight in the challenges of getting 4P business cases funded. We have seen many business cases with a risk profile that was too high. We also observed several cases with serious potential to obtain funding if particular bottlenecks for domestic and international investors are addressed. In this vision paper, we share our observations from the project and conclude with how we believe that the finance gap for agricultural SMEs in 4Ps can be addressed.

Examples from Partnering for Value

During the Partnering for Value project, we identified several high-potential cases. We worked with several local SMEs wanting to improve the quality of their supply through investing in producers, for example by providing them inputs, equipment and training.

One example is a millet processing company in Senegal that had international demand for its products. They experienced difficulties to meet the high international quality requirements and their profit margins were too low to invest. A second example is a soy bean processing company in Uganda, that had

In Uganda, the interest rate for overdraft or term loans is 20-22% - which is fairly similar to other African countries. These rates make it difficult for businesses with such financing, to become profitable.

difficulties to meet demand and wanted to scale up its production by investing in the productive capacity of nearby farmer's cooperatives. So far both cases have been unable to find the required US\$70,000-270,000 needed for their investments.

There is a wide gap between the demand and supply for finance from agricultural SME and smallholders. Before we turn to how we believe international donors can play a role in overcoming this finance gap, we first explain why financial institutions have been reluctant to finance agriculture SMEs so far, to better understand the current bottlenecks.

Current bottlenecks

Both domestic and international financial institutions have indicated several reasons that generally force them to mark 4P business cases as too risky. These are high interest rates², currency & political risk³ and deal size.

Main bottlenecks for domestic financial institutions and markets

Interest rates in many developing countries are significantly higher than in developed countries. The general lack of domestic savings leads to scarcity of working capital for banks. On top of that, domestic banks in developing countries generally take a serious additional margin on top of the interbank rate to cover the volatility and risks in the agricultural sector.

The development and implementation of agricultural financial products requires expert knowledge of agricultural practices and finance. As this knowledge is scarce and expensive, it is unattractive for institutions to create special agricultural financial instruments. At the same time, focusing entirely on agri-finance means that the agro-risk cannot be mitigated with other risks on the balance sheet. This results in severe terms and conditions which make it unlikely that applicants can model a business case towards a positive return.

Main bottlenecks for international financial institutions and markets

Two developments make international financial institutions reluctant to finance SMEs in developing

countries.

First, although the interest rates from international financial institutions are generally lower, these institutions need to be compensated for other risks. We perceived currency and political risks to be major complicating factors in attempts to access international capital for high-potential cases. Funders argued to be willing to co-invest if other parties were willing to take on the currency and political risks involved. They only willing to invest in Euros or US dollars and want to receive their interest, redemptions or dividend in that currency as well.

The second barrier for international financial institutions is the deal size. Transaction costs for these organisations are high as they need an experienced officer to evaluate a business plan and need control mechanisms in place for the post-transaction phase. Therefore, transactions are only possible if these costs can either be reduced, or the deal size is sufficiently large. Where demand of 4P agri-SMEs starts at twenty to fifty thousand Euros, financiers are usually only willing to consider investments from a million Euros or more.

Ways to reduce bottlenecks

We believe that the bottlenecks can be reduced to allow investments to take place. This will accommodate the high-potential 4P cases, enabling SMEs to make the necessary investments to improve their supply and grow their business. We have come to the following recommendations:

a. Invest first in building a pipeline of finance ready cases before commencing financial brokering

In the Partnering for Value Project, we have learned that nearly all 4P cases need a pre-investment phase in which business management capacity is established to make 4P partners investment ready. IFAD works with an abundance of interesting cases in its global portfolio of projects for which this pre-investment phase is key to future success. A pre-investment phase will build a pipeline of cases which are ready for financial brokering. Moreover, IFAD can work together with partners (e.g. the Smallholder Agriculture Finance and Investment Network) to identify new

deals, making use of each other's experience and networks.

In practice, assessing finance readiness means ticking off a checklist: a good business plan, an engaged entrepreneur, annual figures, market data, a good financial model, a clear finance need, and a complete investment memorandum. Only if these items are in place, is it beneficial to invest time and money in a brokering process, as has been done in Partnering for Value. Focussing on qualified leads will lower the cost of the financial brokering significantly.

b. Use public finance to lower stumbling blocks

The investment process in developing countries should be "as simple" as investing in Western countries. We believe that international donors could play a role by:

- Mitigating the currency risks that international financiers face. If the currency exchange risk is covered, international investors can charge lower interest rates compared to domestic investors;
- Mitigating political and country risk, enabling investors to fully assess the risk of the respective SME alone, based on generally accepted ratios. These risks could be mitigated by special insurances or by taking an obligor into a development fund;
- Bundle business cases that do not demand a significant amount of investment, absorbing assessment costs (by granting these costs or providing free Technical Assistance). Investment amounts needed for most 4P cases are approximately between €50,000 and €1,500,000. A donor institution could take these cases on board, bundle them and get them (co-)financed by an external (institutional) investor as a package;
- A donor could act as a co-financier or provide matching funds; private investors will prefer to co-finance with a 'public' investor who takes out the most salient risks.

c. Build local financial brokering capacities

Financial brokering by (independent) services providers helps agricultural SMEs to find investors. This is a specialism that can be learned. The consultants we worked with during Partnering for



Value are well equipped to develop 4P business cases. We do see an opportunity to provide them with better tools and training for the financial brokering side. The project learning documents provide a lot of information, but our recommendation would be to also organise on-site training on financial brokering to really leverage the potential of 4P partnerships.

Concluding remarks

4Ps can benefit from additional investment in their goal to meet an unmet market demand. However, in the Partnering for Value Project we have seen a gap between supply and demand for financing. We argue to address this gap by:

- Implementing a pre-investment phase for 4Ps partnerships
- Using public and donor finances to lower stumbling blocks for the investors, such as bundling business cases into an attractive investment volume.

- Building local financial brokering capacities to improve screening and to match demand with supply.

The crucial objective for financing 4Ps is that the smallholder will benefit from the investment. This should be a condition for any participation of public institutions and international donors in inclusive financing efforts.

Interested to learn more? Detailed insights will be shared in the coming months in a number of knowledge products written by SNV, such as the final 4P Project Paper, 4P Brokering Guidelines and ten case studies. In February 2018, a final learning event will take place at IFAD headquarters.

-
1. With SMEs, we mean formal small and medium agri-enterprises as well as economically active and formally registered cooperatives that operate like an enterprise such as coffee or dairy cooperatives.
 2. Domestic finance mainly
 3. International finance only

For further information, please contact:

Nico Janssen 4P project manager
Ruud M.W. Nijs Finance expert for the 4P project

✉ njanssen@snv.org
✉ ruud.nijs@inclsve.com